Walton GRAT:

Preserving Family Wealth with an Estate Freeze

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Thanks for sharing your time with me today. I'd like to tell you about a powerful and flexible estate planning idea. This strategy is called a "Walton GRAT" and many people are using it to meet their estate planning objectives. It is designed to help preserve wealth from estate taxation by transferring the future growth of assets outside of a family's estate today.

This technique can also be used as an "exit strategy" for other planning techniques such as premium financing or private split-dollar.

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Three Questions

- Do you have assets whose future growth may create an estate tax problem and which you would like to preserve intact for your children or grandchildren?

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I have three questions for you to consider:

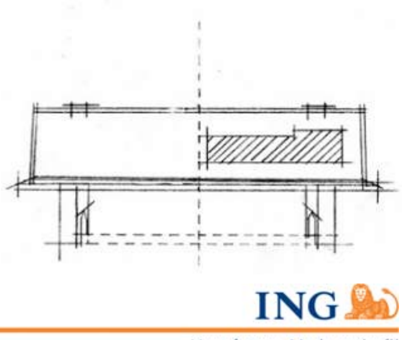
First:

Do you have assets whose future growth may create an estate tax problem? These could include any high-growth assets such as shares in a closely-held business, real estate, or the family farm.

For example, an asset worth $1 million today, if expected to grow at an annual rate of 10%, would be worth over $2.5 million in 10 years and over $6.7 million in 20 years. What may not be an estate tax problem now could pose a real problem at death?

Three Questions

- Do you have assets whose future growth may create an estate tax problem and which you would like to preserve intact for your children or grandchildren?
- Do your insurance needs call for premiums that exceed the available annual exclusions for potential "Crummey" beneficiaries?



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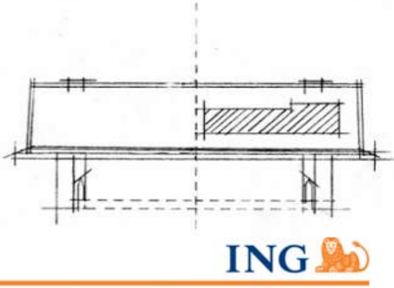
Second:

Will you be paying insurance premiums that exceed your available annual exclusions?

Perhaps, with the help of your financial professional, you have already identified a large insurance need and the projected premiums are greater than the annual exclusions you have for potential Crummey beneficiaries (i.e., trust beneficiaries who in 2009 would be able to withdraw up to $13,000 per year or $26,000 per year if you are married – this amount is indexed for inflation and may go up in future years). Using a GRAT to pre-fund a trust to purchase the insurance may help solve this potential gift tax problem.

Three Questions

- Do you have assets whose future growth may create an estate tax problem and which you would like to preserve intact for your children or grandchildren?
- Do your insurance needs call for premiums that exceed the available annual exclusions for potential "Crummey" beneficiaries?
- Would you like to reduce some of the potential long-term risks associated with premium financing or private split-dollar?



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Third:

Are you worried about potential long-term risks associated with other planning techniques?

You may be considering using premium financing, private split-dollar, or a similar technique to fund the purchase of a life insurance policy. But you are also aware of some potential long-term risks. For example, rising interest rates may make a premium financing arrangement less attractive after five or ten years. Or you may be concerned about the rising gift amounts created as the insured in a private split-dollar arrangement grows older (recall that the gift cost is related to the cost of providing term insurance--the older the insured, the higher the amount of the gift).

Funding a trust through a Walton GRAT may give the trustee resources to terminate these other arrangements if needed.

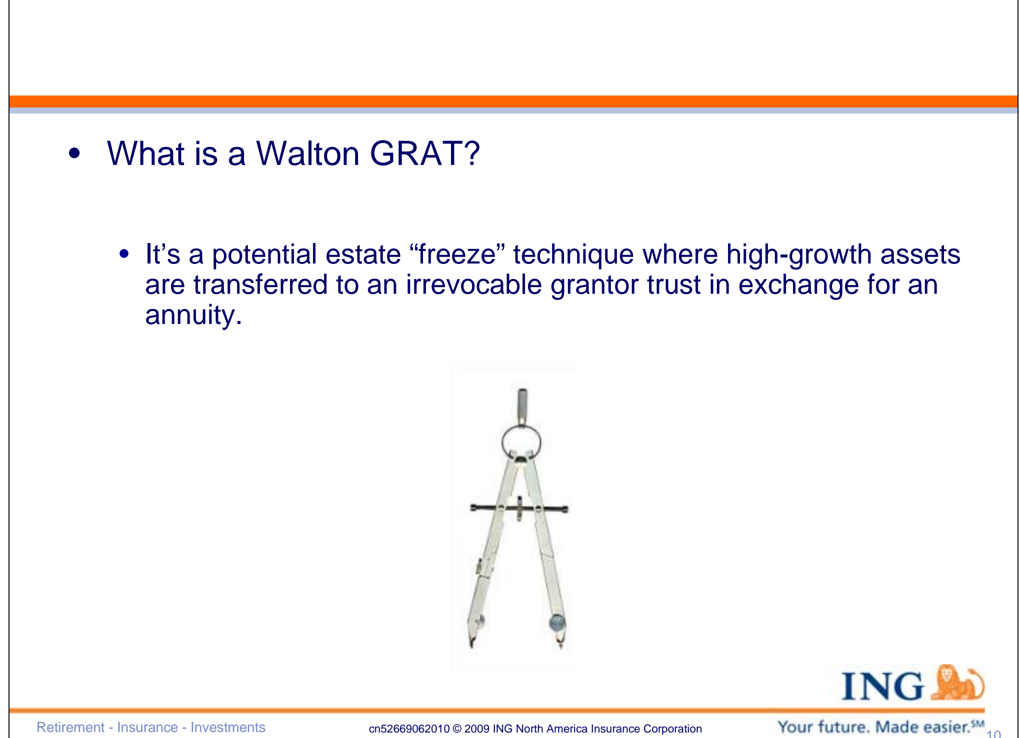
Is there a way to potentially "freeze" the value of my estate so that I don't pay gift or estate taxes on future asset growth?

Is there a way to potentially pre-fund an insurance trust so I don't have to worry about keeping premium levels within my annual gift exclusions?

Is there a way to potentially provide my insurance trustee with resources to make an early exit from premium financing, private split-dollar, or other similar strategies?

Yes.

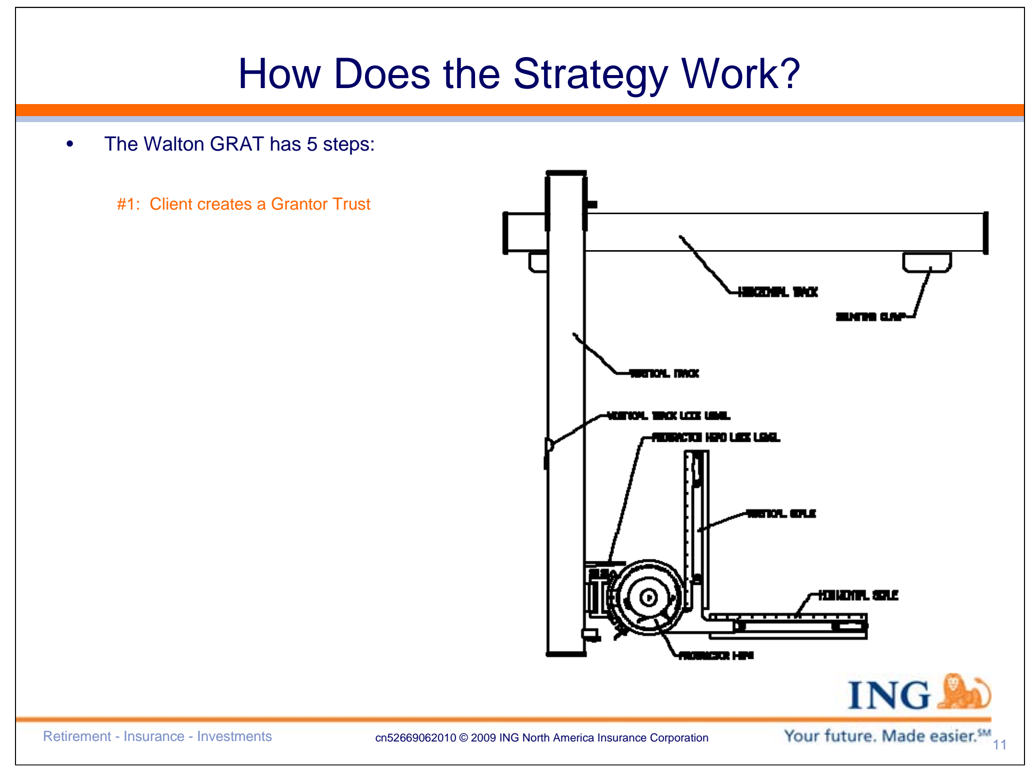
The “Walton GRAT” technique is a flexible strategy which may be able to help address any or all of these needs: “freezing” estate values, pre-funding an insurance trust, or providing an exit strategy for other techniques such as premium financing or private split-dollar.



A grantor retained annuity trust ("GRAT") is an estate freezing technique which has the potential to help clients remove future growth from the value of a taxable estate. A Walton GRAT, named for its use by the Sam Walton (Wal-Mart) estate, is a GRAT that has been structured so that there are virtually no gift taxes generated by the creation and funding of the GRAT.

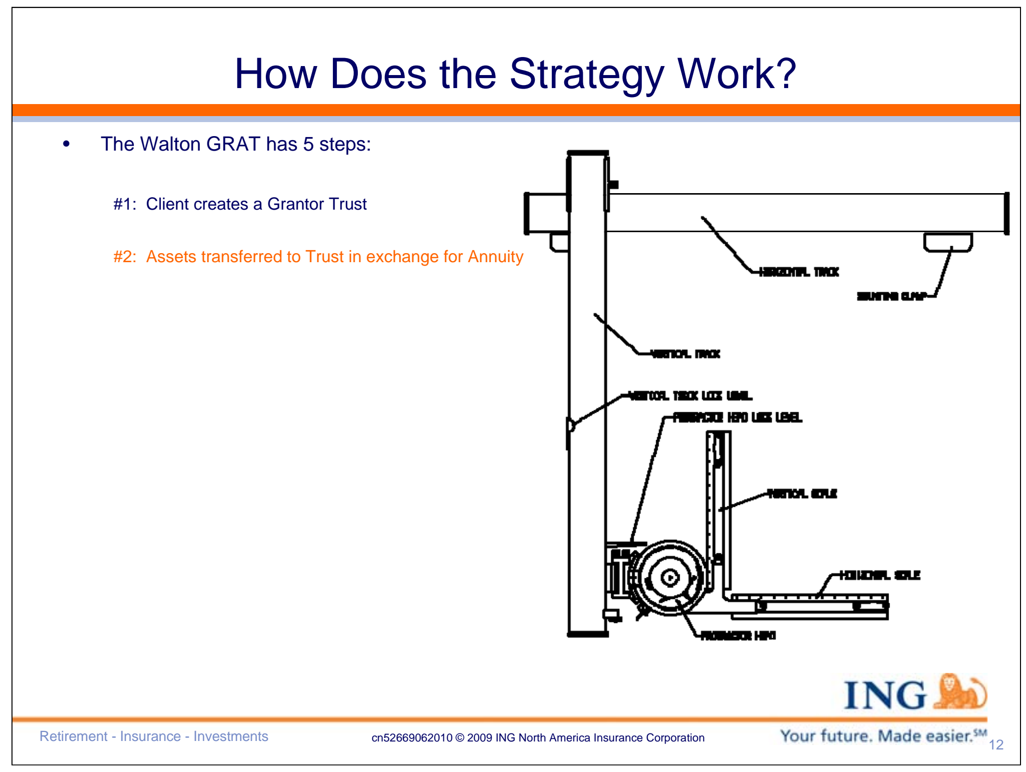
The grantor contributes high-growth assets to a grantor trust based on today's values in exchange for annuity payments based on interest rates set by the IRS. If the assets grow at a rate higher than the IRS interest rate, all excess growth passes to the trust beneficiaries free of estate and gift taxes. If, however, the assets do not grow at a rate higher than the IRS interest rate, or if the assets lose value, then nothing will be left at the end of the GRAT term to pass to the trust beneficiaries.

According to IRS regulations, a GRAT must be structured as a grantor trust. This is a trust which is structured to be treated as being identical to the grantor for income tax purposes. This means that the transfer to the trust has no income tax consequences, although the grantor will still pay taxes on any income generated by assets in the trust which will enable those assets to grow income-tax free for the trust beneficiaries.

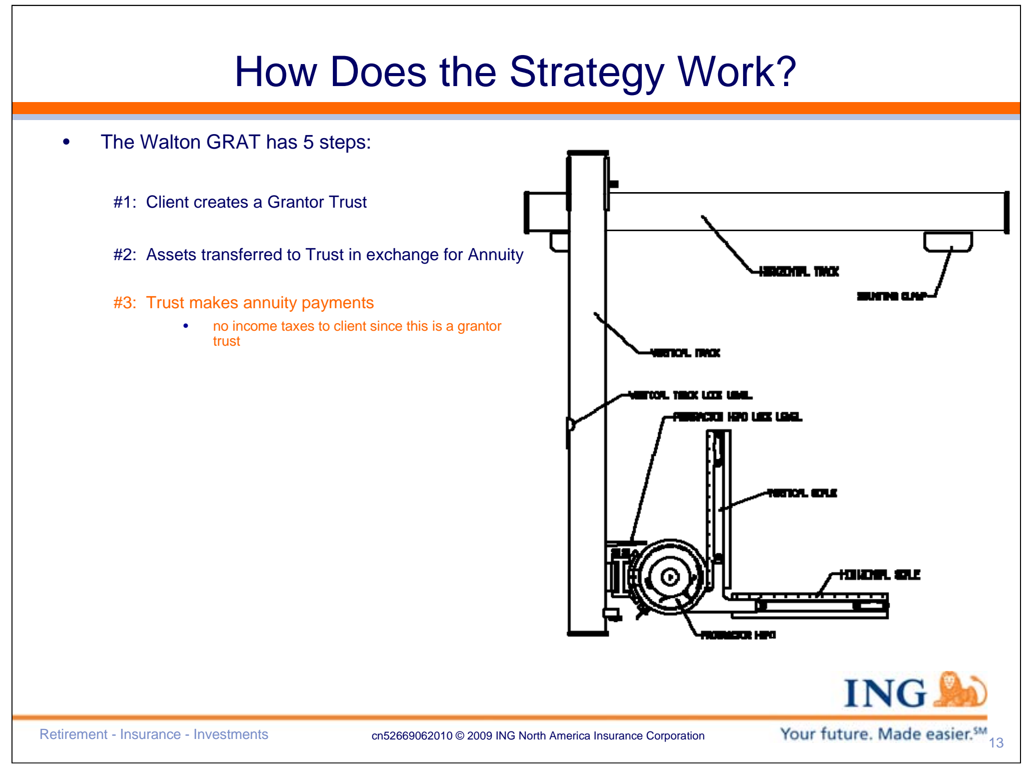


Using a Walton GRAT involves five steps.

The first step is to have the client's attorney create a grantor trust. This is an irrevocable trust which is specially designed so that the trust assets are excluded from the grantor's estate for estate and gift tax purposes, but the assets are treated as belonging to the grantor for income tax purposes.



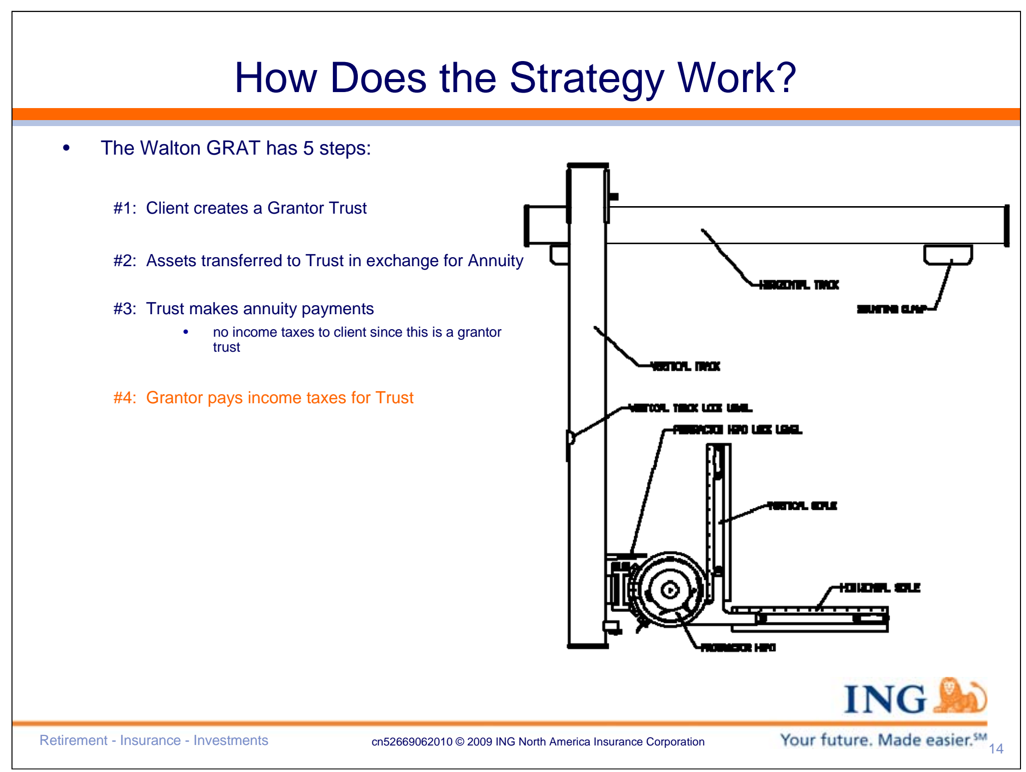
The second step is to transfer assets into the trust in exchange for an annuity. The annuity must be for a “fixed amount” and be for either a term of years or for the life or lives of the grantor(s).



The third step is to have the Trust make scheduled annual payments to the grantor.

As already mentioned, the IRS requires GRATs to make “fixed” annuity payments. The payments must be based on either a stated dollar amount or a stated percentage of the value of the assets contributed to the Trust. Although the IRS regulations call the payments “fixed,” the regulations allow the scheduled payments to systematically increase or decrease by as much as 20% a year.

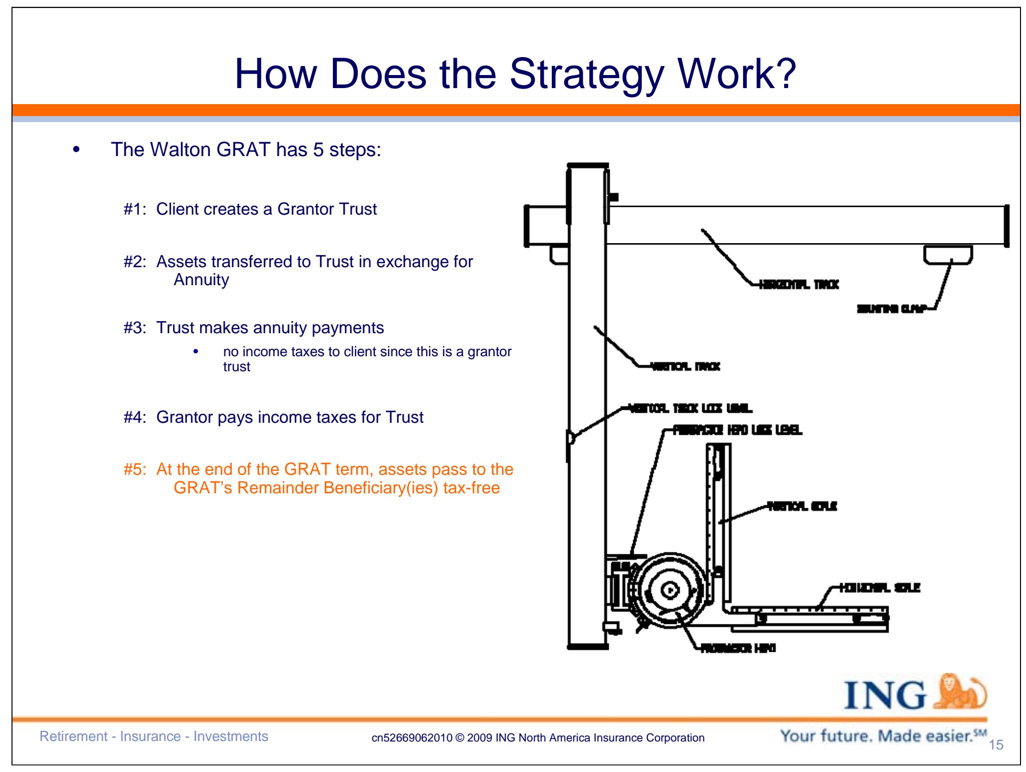
Also, since the Walton GRAT is a grantor trust, the annuity payments do not create taxable income for the grantor(s).



Step four is for the grantor to pay income taxes on the Trust's income.

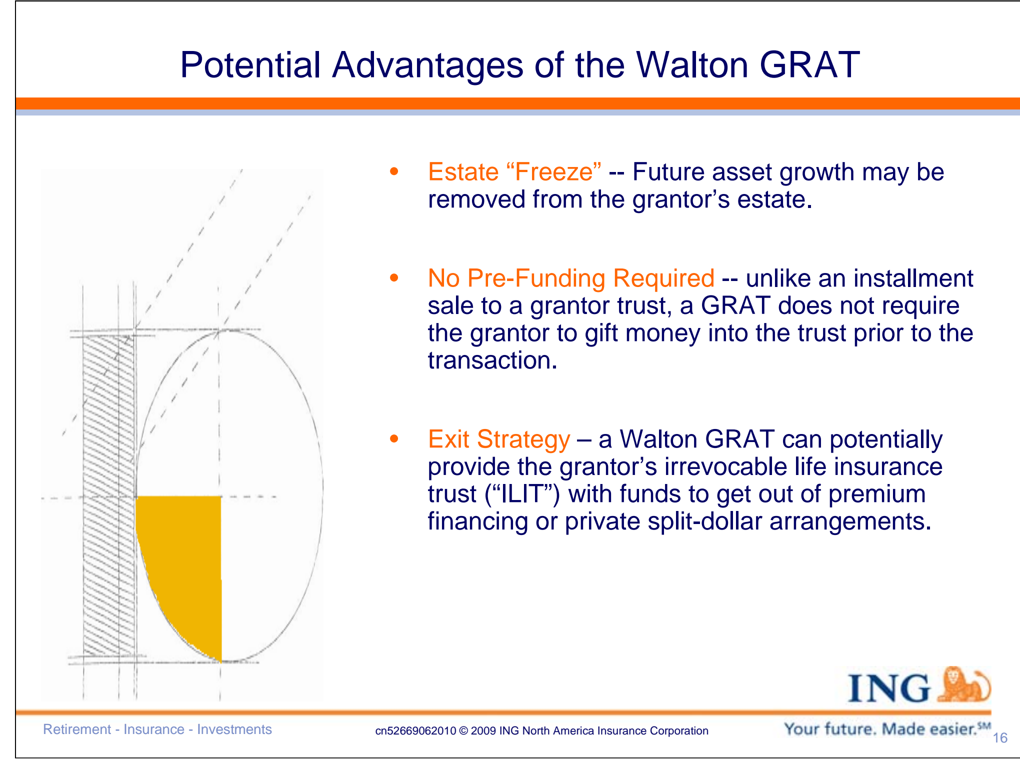
This is the equivalent of a potential tax-free gifting opportunity for the grantor. If the grantor had given the assets directly to his or her children, the children would be obligated to pay the taxes on income generated by the assets. In that situation, if the grantor paid the income taxes for the children, the grantor would potentially have to pay gift taxes, too.

By paying income taxes for the trust, the grantor enables the trust assets to grow income tax-free for the trust beneficiaries.



Finally, if the grantor outlives the term of the GRAT, the trust assets will pass to the GRAT's remainder beneificiaries free of any estate taxes. The remainder beneficiaries could be the grantor's children or the remainder beneficiary could be an ILIT which the grantor has established to purchase life insurance.

If the grantor dies before the GRAT term has expired, then all of the trust assets are brought back into the estate. Because of this, the grantor may want to limit the length of a GRAT and may even want to purchase life insurance to provide additional benefits during the GRAT term.



We’ve already talked about some of the advantages of a Walton GRAT:

Estate “Freeze” -- Future asset growth is removed from the grantor’s estate.

No Pre-Funding Required -- unlike an installment sale to a grantor trust, a GRAT does not require to gift money into the trust prior to the transaction.

Exit Strategy -- a Walton GRAT can potentially provide the grantor’s irrevocable life insurance trust (“ILIT”) with funds to get out of premium financing or private split-dollar arrangements.

Some Disadvantages of Walton GRAT

- Estate Inclusion -- if the client dies before the GRAT term has finished, all of the assets are brought back into her estate.
- Performance Risk -- the Walton GRAT technique only works if the asset used grows at a higher rate than the interest required for the annuity.

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Of course, the Walton GRAT technique also has some possible disadvantages:

Estate Inclusion -- if the client dies before the GRAT term has finished, all of the assets are brought back into her estate.

Performance Risk – the Walton GRAT technique only works if the asset used grows at a higher rate than the interest required for the annuity.

- John & Jane Jones are married, both age 55, and own $2 million worth of stock in the highly successful Widget Corp.
- John & Jane expect shares of Widget Corp. to continue increasing in value at an annual rate of 10%
- They are willing to give up ownership of the stock in exchange for an income stream. They are also willing to use a portion of their lifetime gift exemptions to move future asset growth out of their estates.

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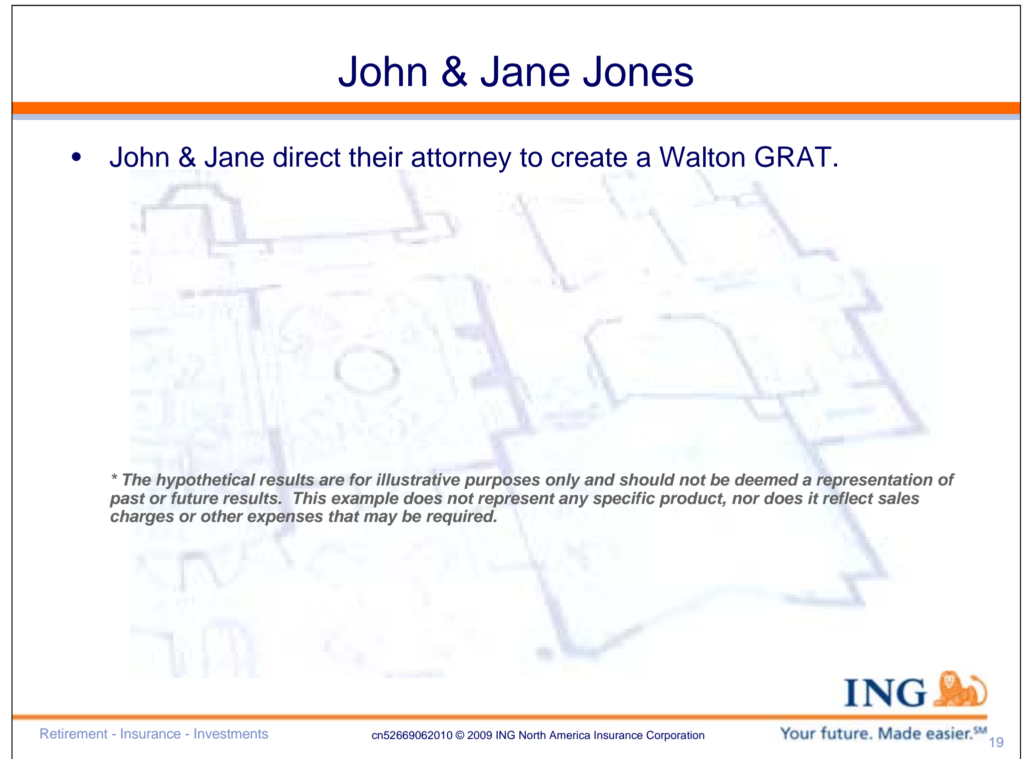
Let's look at an example of how the Walton GRAT Strategy can be put to use.

Assume a couple--John & Jane Jones--with $2 million worth of stock in a small company--Widget Corp.--which has been growing at 10% per year. John & Jane may not have an estate tax issue now, but they believe this rapid growth could create a tax problem 10 or 20 years in the future. They want to "freeze" their estate at present values.

Working with their financial advisor, they decide that contributing the shares to a Walton GRAT makes sense.



So what do John & Jane do?

First, working with their attorney, they create a GRAT--a “grantor retained annuity trust.”

John & Jane can direct their attorney to model the GRAT after the Walton decision so as to have a “zero gift” transfer.

John & Jane Jones

- John & Jane direct their attorney to create a Walton GRAT.
- John & Jane then transfer $2 million worth of Widget shares into the GRAT in exchange for a 10-year annuity based on a Section 7520 rate of 2.40%.**

** The hypothetical results are for illustrative purposes only and should not be deemed a representation of past or future results. This example does not represent any specific product, nor does it reflect sales charges or other expenses that may be required.*

*** This was the § 7520 rate in effect for March, 2009.*

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Next, John & Jane transfer the $2 million worth of Widget shares to the Trust in exchange for an annuity. In our example, the GRAT will make annuity payments to the Jones over 10 years with payments based on a rate of 2.40%.

The annuity rate is based on 120% of the mid-term applicable federal rate (or "AFR") published by the IRS in the month the GRAT is formed. This rate is also known as the Section 7520 rate.

John & Jane Jones

- John & Jane direct their attorney to create a Walton GRAT.
- John & Jane then transfer $2 million worth of Widget shares into the GRAT in exchange for a 10-year annuity based on a Section 7520 rate of 2.40%.**
- The Trust makes annual payments of $227,337 for 10 years.

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The Trust will make annual payments to the Jones of $227,337. These payments will last for 10 years.

What Have We Potentially Accomplished?

- Estate Freeze: At the end of 10 years, John & Jane have moved over $1.5 million outside of their estates (assuming at least one of them survives the GRAT term).
  - No transfer taxes have been paid and the use of a grantor trust makes the sale income-tax neutral because the GRAT is ignored for income tax purposes.

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So what have John & Jane potentially accomplished?

First, while receiving over $2.2 million in payments from the Trust, they have moved $1.5 million outside of their estates. Assuming continued 10% annual growth, over $3.8 million will be removed from their estates after 20 years! This assumes that either John or Jane (or both) out live the 10-year GRAT term.

Meanwhile, no estate or gift taxes have been paid. And there are no income taxes generated by the annuity payments because the GRAT is ignored for income tax purposes.

What Have We Potentially Accomplished?

- Estate Freeze: At the end of 10 years, John & Jane have moved over $1.5 million outside of their estates (assuming at least one of them survives the GRAT term).
  - No transfer taxes have been paid and the use of a grantor trust makes the sale income-tax neutral.
- Funded Life Insurance Trust: Assets transferred from the GRAT to the ILIT (the remainder beneficiary) can be used to purchase life insurance on John and/or Jane to create a larger inheritance for their family.
  - Unlike a traditional life insurance trust, annual exclusion gifts may not be needed for the Trust to purchase life insurance.

Second, if the Jones want to increase the inheritance they are providing to their children, the assets left to the ILIT as remainder beneficiary can be used to fund the purchase of life insurance outside of their estates.

Most irrevocable life insurance trusts rely on annual donations to pay life insurance premiums. This means the grantors have to use annual gift exclusions and requires the trust to include “Crummey” withdrawal provisions. Since the Walton GRAT can potentially provide the trust with funds, clients may not need to worry about annual gifts or withdrawal powers.

What Have We Potentially Accomplished?

- Estate Freeze: At the end of 10 years, John & Jane have moved over $2.9 million outside of their estates (assuming at least one of them survives the GRAT term).
  - No transfer taxes have been paid and the use of a grantor trust makes the sale income-tax neutral.
- Funded Life Insurance Trust: Assets inside the Trust can be used to purchase life insurance on John and/or Jane to create a larger inheritance for their family.
  - Unlike a traditional life insurance trust, no annual exclusions will be needed for the Trust to purchase life insurance.
- Exit Strategy: John & Jane have supplied the Trustee with assets which can be used to "exit" premium financing or private split-dollar arrangements.

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Alternatively, if John & Jane are using an existing ILIT which has already purchased life insurance, the Walton GRAT can be used to provide funds needed for an "exit strategy."

With both premium financing and private split-dollar, the cost of the transaction increases with time. A Walton GRAT provides funds for getting out of these strategies when and if they become too expensive.

Of course, the best illustration is one which relates to YOU.

Let me show you how a Walton GRAT can work for your family with a customized illustration using your assets, your assumptions, and your goals.